

AN ANALYTICAL COMPARISON OF
VARIOUS CONCEPTS OF BUSINESS INCOME
AFFECTING THE ACCOUNTING FUNCTION OF
INCOME DETERMINATION

by

ROBERT J. MONROE

B. S., KANSAS STATE UNIVERSITY, 1961

A MASTER'S REPORT

submitted in partial fulfillment of the
requirements for the degree

MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1965

Approved by:

M. E. Guider
Major Professor *mc*

10
2608
R4
1306
M753
- 2

TABLE OF CONTENTS

INTRODUCTION	1
SIGNIFICANCE OF ACCOUNTING REPORTS TO VARIOUS GROUPS CONCERNED.	4
Accounting For Management	4
Legal Uses of Accounting Reports.	8
Public Reliance on Accounting Reports	14
Economics and Accounting Reports.	16
ECONOMIC CONCEPTS OF INCOME.	18
ACCOUNTING INCOME.	27
ACCRETION INCOME	31
COMPLETELY SUBJECTIVE AND OBJECTIVE INCOMES.	33
SUMMARY.	35
CONCLUSION	38

INTRODUCTION

One of the principal functions of accountancy is the determination and reporting of income. On the surface, the accountant's task appears to be clear-cut, well defined and relatively simple. In addition, the average layman believes that the principles and procedures followed to report income are easily established, objective and satisfactory to all concerned. However, anyone familiar with income determination or one who must base decisions upon "income" as measured in accounting fashion, will agree that there is little agreement as to procedure, purpose or the value of the end result.

An accountant of long experience was sharply critical of the accountant's income in making the following statement. "Fifty years ago when I completed my first course in accounting----I knew the meaning of income----. There was no doubt in my mind. After fifty years of study and practice I can not give you a definition that will satisfy my conscience."¹

Basic accounting procedures are founded on the double entry bookkeeping system which was in existence prior to the fifteenth century. Why then has the problem of income measurement come into focus more clearly the last fifty years? Two reasons can be cited for this development. First, accounting has expanded into areas more involved than the mere recording of data. Second and more important, the business environment within which accounting operates has undergone rapid and extensive changes in recent years. This different

¹ H. T. Scovill, "Efforts to Define Business Income", The Accounting Review, October 1952, 27:458.

environment produces more complex transactions and events to be recorded, analyzed and reported by the accountant.¹

Four significant causes of the changes in business environment can be observed. First, today witnesses a great increase in the size and number of corporate forms of businesses attracting large sums of capital from numerous small investors. Furthermore, manager and owner are no longer synonymous terms. No longer does the accountant prepare reports to be read and relied upon only by businessmen familiar with the terms, procedures and problems of recording and reporting business transactions. Accountancy has been given the task of reporting the results of operations to various groups, each having different viewpoints, interests and backgrounds.

A second factor in this change is the increasingly complex tax laws. Each business decision and transaction must be considered in light of the tax impact.

Third, the growth of big government and its far reaching tentacles of control has brought about vast changes in the business environment. No longer can an enterprise operate independently of a government that requires detailed reports of operations.

Finally, the increased size of business itself has brought many changes. The problems of recording transactions and reporting results for a multi venture corporation with numerous geographical locations has become enormous when compared to those of the one-owner proprietorship of the eighteenth century.

George O. May stated that there are five "newer uses"² of accounts which have developed during the last fifty years. The following new uses of accounts

¹ Loc. cit.

² George O. May, Business Income and Price Levels, Study Group on Business Income, p. 82.

indicate specific needs that have arisen because of the developments cited above:

- 1) Supply information to prospective corporate investors;
- 2) A guide to the value of committed investments;
- 3) An aid to government supervision and economic policy;
- 4) A basis for regulation of prices or rates of charge for service; and
- 5) A basis for taxation.

All of the newer uses of accounts mentioned above rely heavily on information concerning income. Not only has the subject of income determination been emphasized in recent years, but it has also taken on new and broader meanings. Various groups have used the term to describe many different things. The question of what is being measured by income is one on which there is widespread disagreement.

Income may refer to individual income, income of an enterprise, a venture, a group of people, or income of a nation. The current discussion of the subject will be limited to business income--the income of an enterprise. In dealing with business income, time is of primary importance. Were it not for the necessity of measuring income for a period of time shorter than the life of the enterprise, a major part of the income problem would not exist. Another aspect of the subject that occasions much debate is the unit of measure to be used. In short, income determination becomes a problem of determining what is to be measured, over what time period it is to be measured and what units of measurement will be used.

Various procedures used to determine income are subject to much debate, and are criticized for being non-objective, unreliable and inconsistent. As a result numerous definitions and concepts of income have developed.

The purpose of this paper is to discuss the various uses and concepts of income and analyze the basic differences in these concepts in light of the

accounting problems of measuring and reporting income.

SIGNIFICANCE OF ACCOUNTING REPORTS TO VARIOUS GROUPS CONCERNED

Unlike the techniques used by many professions and skills, accounting techniques and procedures were not discovered. New uses of accounting data and new functions and tasks for the accountant occurred over the years, but accounting practice and theory have developed as an outgrowth of needs. Much criticism is heard of the inflexibility of accountancy to adapt its practices to the needs which it is serving. In great part this criticism is rightly made. However, accounting history indicates this is not characteristic of the profession. The unwillingness of accountancy to make necessary adaptations in recent years can more nearly be attributed to the dilemma of attempting to serve numerous interests, few of which have similar needs. As a result, accounting practice has failed to fully adapt itself best to any one of the areas for which it is providing essential information.

Accounting for Management

Present-day accounting is an outgrowth of basic bookkeeping procedures used in Italy. Its development was directed toward the task of accounting for wealth and the changes therein of individual merchants. As the use of common mediums of exchange increased, the practice of accounting for wealth and exchanges thereof in terms of these equivalent units also increased. In comparison to measurements in terms of numerous commodities, these mediums of exchange proved to be a more common and stable measure of value, making accounting statements more comparable to each other over long periods of time. During this

period of time when common mediums of exchange first became widely used, accounting procedures were easily applied to relatively short periods of time. This was primarily due to the lack of credit and the fact that the major type of business activity was trading.

Early accounting procedures resulted primarily from the proprietor's need for information concerning past progress. As trade became more complex and business organizations grew in size, there arose a need to account for large sums of capital invested in an enterprise of many ventures. The accounting process no longer included only the recording of exchanges of wealth. It became necessary for record keeping to adapt itself to a system which would account for the capital or proprietorship account and changes therein. One writer states that "the clue to bookkeeping logic lay in proprietorship.---- In the nature of proprietorship is the basis for the fundamental distinction between assets and expenses which underlies so much of the theory of accounts."¹

It is apparent from these early developments of accounting that the concept of stewardship or accounting for ownership was of primary importance. Owners of wealth were also the managers, but accounting information was not prepared primarily as a basis for management decisions. This early emphasis on assets, liabilities and proprietorship has had its part in influencing accounting procedures. The traditional procedures used in recording transactions and preparing financial statements for trading enterprises have greatly influenced current accounting practice regarding the preparation of financial statements.

¹ A. C. Littleton, Essays on Accountancy, p. 15.

The introduction of the corporate form of business in the United Kingdom with limited liability and continuity of existence called for further developments in accounting methods. Responsibility for management was placed in the hands of a small group of individuals who were responsible for the preservation of capital for creditors and owners alike. The managers were also made responsible for a fair and equitable distribution of profits. With these developments, the distinction between capital and income became more important to those concerned. Even with this increase in management's specific needs for accounting data the emphasis was on external reporting. George O. May suggests that accounting data had four primary uses during this period of time.¹

- 1) As a report of stewardship
- 2) As a basis for fiscal policy
- 3) As a guide to wise dividend action
- 4) As a basis for the granting of credit

Mr. May also points out that "the four older uses of accounting do not present any conflict so marked as to make difficult the formulation of general purpose accounting conventions that would serve them well."² From this point in the early twentieth century until the present time the uses for accounting information have increased in number and these additional uses do present conflicts which make difficult the formulation of general purpose accounting conventions that will serve them all well.

These older uses can all be related to the need of management for accounting data. In recent years the area of administrative accounting has been developed to provide management with additional information useful in solving new problems of management.

¹ May, op. cit., p. 7.

² Loc. cit.

Dividend distributions pose problems for management that require adequate information concerning past progress but which must be solved in view of future operations. Since dividend policy is based primarily on earnings records, the determination of income becomes an important aspect of the related decisions. Historical accounting information is not entirely adequate for such use primarily because of the limitations in the unit of measure. Corporate management is concerned with the perpetuation of the organization and the replacement of depreciating facilities. It must collect information on future costs of capital facilities and future income streams before making decisions regarding the distribution of reported income.

Information concerning costs and the distribution thereof is an important tool for establishing prices. It is agreed that a firm's costs do not dictate the price to be received for goods in the market, however, detailed information regarding the costs makes possible more competitive pricing policies.

Cost control and budgeting is another area of concern to management and one which is far removed from the reports of the eighteenth and nineteenth century bookkeepers.

Traditional accounting reports alone will not satisfy these and numerous other needs of corporation management for financial data. This deficiency in accounting statements and reports is primarily centered around two major problems.

The first of these is the long lapse of time occurring between outlays of assets by business organizations and the anticipated returns resulting from the outlays. These expenditures must be carried along, broken down and deducted from some future income. This emphasizes the point made earlier in the paper that one of the greatest problems in income measurement is the distinction between the periods of time for which income is to be measured.

The other basic problem inherent in each of the uses is the difficulty of comparing units of expenditures made in prior periods with units of revenue from later periods of time--units which are not equal in size.

It is not unreasonable to assume that management requests for useful accounting data will increase and that the present problems in supplying these data will become more complex. Traditional accounting procedures that once produced adequate information for management purposes must continually be analyzed and revised where necessary.

Legal Uses of Accounting Reports

The early days of the accounting profession were not characterized by a close association with the legal profession. There was not a mutual dependence one on the other like that of accounting and management. However, as increasing legal requirements and restrictions were placed on business, it was natural to look to the accountants to supply legal authorities with the necessary information regarding the enterprise, its wealth and its income. Although a considerable portion of the legal-business problems concern the distribution of equities upon the dissolution of business organizations, a majority of the problems are directly related to income determination. Requests for accounting data from legal sources have not been without suggestions and stipulations of the procedures to be used to obtain the information. In numerous cases statutory requirements dictate the accounting procedures to be used. These requirements whether statutory or not have had a considerable effect upon accounting concepts and theory.

In the following paragraphs an effort has been made to set forth some of the basic points of contact between law and accountancy in an effort to define

the problems of providing information useful and satisfactory to both groups involved.

Undoubtedly the most influential and far reaching requirement placed upon business and accounting by law is the income tax. One writer has stated that the greatest amount of confusion caused by external influences on accounting is found in the area of taxation.¹ This can primarily be attributed to the basic differences in purpose for measuring income among those concerned. Management views income as a result of past effectiveness and as a basis for planning. Tax authorities are not solely concerned that income determined in accordance with tax laws represent increases in economic power over the period. They are concerned with establishing a basis for taxes;--taxes which are not intended to be levied on absolute increases in the enterprise's command over goods and services. The measurement of taxable income is also affected by numerous

groups seeking tax advantages for some specific segment of income. The following paragraph describing the philosophy of taxation clearly indicates concepts and viewpoints of income much different than those held by the accounting profession or any other group concerned.

"It had already been decided that the taxing power need not be restricted to the object of raising revenue. It is the power to destroy. If it can be used to destroy it can probably be used for any lesser purpose such as to punish, prevent, restrict and regulate anything within the now infinitely broadened scope of taxing power."²

This statement was originally made in 1938. By now almost everyone will agree that tax laws are not designed only to collect an equitable portion of the

¹ Stephen Gilman, Accounting Concepts of Profit, p. 16

² Ibid., p. 18.

increase in one's wealth. The power to regulate has become a major factor in the formulation of the concepts of taxable income.

There will be no attempt here to reconcile the points of difference between theories of income held by taxing authorities and accountants. It is a well established fact that accounting for tax purposes and for book purposes must follow different procedures. This separation of methods has not, however, eliminated tax law influence on income determination procedures. The cost or market rule for inventory valuation is evidence that such influences have been prevalent. William A. Paton writes concerning the cost or market rule that "the early American enthusiasm for the device among trade associations, business management, and corporate accountants was not a tribute to the merits of the scheme as a worth while accounting mechanism; but as an immediate method of reducing taxable income. It waxed on account of considerations far removed from the development of sound accounting."¹ Within certain limits it is reasonable to believe that conservative income accounting such as produced by the cost or market rule was welcomed by business management. Big business constantly hears the criticism of too much profit from labor and the public. Secondly, the stockholders' desire for an increased amount of profit distributions is increased by large accounting profits.

Regulatory agencies have been given an increased amount of responsibility and authority in recent years to determine what is a fair, equitable and fully disclosed income. In many instances these agencies have also prescribed and required specific procedures for the measurement of income.

¹ William A. Paton, "A Statement of Accounting Principles", Journal of Accountancy, March 1938, 63:202

It is a well established fact that the Securities and Exchange Commission has had a significant influence on accounting principles in past years. Public accountants have no alternative in many cases but to employ S.E.C. procedures in the preparation of financial statements for public distribution. The S.E.C., although more influential than most regulatory agencies, is not alone. Legal influence upon accounting theory is exerted by the Federal Trade Commission, Interstate Commerce Commission, numerous public utility commissions, national and state legislators and the courts. These groups are all directed for the most part by men with a legalistic view of income. An editorial in the Journal of Accountancy expresses this in the following manner.

"The statutory law which by its very nature must be controlling, is written by lawyers with a lawyer's concept of duty. When it treats of accounting matters it frequently conflicts with what accountants have come to look upon as 'accepted practices'."¹

Item 26 of schedule A to the Securities Act of 1933 requires a profit and loss statement from those companies offering securities to the public. It also provides that the profit and loss statement required by such items be in such detail and such form as the S.E.C. shall prescribe.² For the most part the S.E.C. has operated on the basis that generally accepted accounting principles should be employed for their purposes. This, however, leaves a large gray area in which they can determine what generally accepted principles are. One example of discrepancies among interpretations of generally accepted principles is the way in which income taxes are charged to the income statement. An expense should

¹ John L. Carey, "Legal and Accounting Concepts", Journal of Accountancy, November 1938, 66:281

² Arthur H. Dean, Business Income Under Present Price Levels, p. 79.

normally be charged to income during the period in which the corresponding revenue is recognized. However, an expense may be charged against income for tax purposes in a different period than when it is charged against income in financial statements.¹ In the Accounting Research Bulletin #23, the American Institute of Accountants recommends that in certain cases tax charges should be allocated as other expenses. This recommendation has been widely followed in corporate accounts but is not wholly acceptable to the S.E.C.²

Tax laws have had their influence upon accounting principles through their long and close association with those instrumental in determining these procedures. The S.E.C. however, has more directly affected the income determination process because of the statutory requirements established by it for general publications of financial statements.

Another aspect of the legal influence on accounting practice is that of the numerous state and federal statutes which establish and regulate corporate forms of business. Such regulations placed on corporate dividend distributions are primarily related to the measurement of income and capital. "The Delaware state statute provides that dividends may be declared either out of net assets in excess of capital----or in case there be no such excess, out of net profits for the year then current and for the preceding fiscal year."³ Other state statutes are similar in their provisions. In many cases specific requirements are set down for the determination of this income. One need only to consider the objectives of such regulations to conclude that practices for determining income under them are apt to be much different from accounting practices.

¹ Additional first year depreciation deductible for tax purposes poses such a problem.

² May, Op. cit., p. 18.

³ Dean, Op. cit., p. 69.

Primary consideration is given to the protection of permanent capital, especially that of the creditors, from depletion because of distributions of dividends to common shareholders. Statements prepared by accounting standards, however, are the primary source of information available concerning current and past earnings.

Legal concepts of business, its purpose, and business income undoubtedly have influenced the preparation of financial statements in numerous ways which were not discussed here. Those most influential, however, are those discussed above: tax regulations, regulatory agencies and statutory requirements regarding corporate forms of business.

It is not possible to present a clear cut legal concept of income. Within the area of law alone, no well established definitions of income or procedures for measuring it are uniformly held forth. The purposes and objectives in measuring business income are numerous and in many instances dissimilar. It is the responsibility of accountants, however, to objectively measure this undefined income and provide financial statements useful for all concerned. In view of this it is not surprising that such harsh criticisms as the following from Justice Jackson's opinion in the *Hope Gas* case have frequently been directed toward the accounting profession and the services it provides.

"As a representation of the conditions and trend of a business it (accounting) uses symbols of certainty to express values that actually are in constant flux. It may be said that in commercial or investment banking or any business extending credit, success depends on knowing what not to believe about accounting.----However, our quest for certitude is so ardent that we pay an irrational reverence to a technique which uses symbols of certainty even though experience again and again warns us that they are delusive. Few writers have ventured to challenge this American idolatry."¹

¹ Dean, Op. cit., p. 77.

Public Reliance on Accounting Reports

Much of the accounting data required by law and necessary for effective management is a result of the growing need and demand for public information concerning the progress of a business organization. Businesses today cannot operate in a vacuum. The advent of the corporation made it necessary to report the financial success of a firm to numerous individuals directly or indirectly related to the business itself. The large accumulations of capital characteristic of the corporate form of organization and mass production have caused a need for large concentrations of labor dependent upon one business enterprise. The large number of small investors and laborers are dependent upon the successful continuation of the firm and are genuinely interested in financial statements and reports. As business organizations have grown in size, large concentrations of the population have become economically dependent upon the operation of the business organization. This dependence has become so great that social responsibility has been given added consideration by business management. The type of information needed and expected by the public is a problem faced by business managers and accountants.

One publication entitled How to Read an Annual Report¹ suggests that there are two questions generally asked by shareholders when reading a financial report. These are:

- 1) How much better off personally am I as a result of the company's operations?
- 2) How long can this condition be expected to last?

¹ Stuart Chase, How to Read an Annual Report, p. 2.

It is not necessary to point out the weaknesses in detail, but the information presently contained in annual reports will not satisfactorily answer these questions without a considerable amount of adjustment. Accounting treatment of such items as depreciation, capital gains or the application of the realization principle are points of confusion to the average report reader.

Income distributable to stockholders is an item of special interest to investors in evaluating their investment. In this respect an income above the cost to replace depleted and depreciated assets would be more appropriate to consider than income after deductions for the expiration of outlays made in the past. Frequently dividend policies are criticized by investors because of a lack of information reported by the financial statements on the matter.

Labor groups base demands for increased wages on income reported by accountants and upon current living costs. Their interest lies in the purchasing power of income. Standard financial statements do not provide these groups with the desired information.

"Accounting has a much greater importance to society than simply helping management to attain efficient and profitable production. The growth of business organizations, plus pressures from stockholders, creditors, and government agencies, have increased the amount of financial disclosure which must be made public. Access by outsiders to a great deal of corporate information is now a generally accepted right. A society which has a high degree of freedom of choice must have adequate and correct information in order to make such important decisions as whether to invest, buy, sell, or lend. Voters are called upon to decide issues which hinge upon knowledge of financial data."¹

¹ Donald A. Corbin, Accounting and Economic Decisions, p. 4.

Economics and Accounting Reports

"Economics is the study of the production and distribution of goods and services and the study of methods for improving the system of production and distribution."¹ The relationship of economics and accounting may be viewed in two different ways. That accounting is a branch of economics is expressed by one author. "Economics is the broad field of study-----accounting is that portion of this field which concentrates on gathering, classifying and interpreting information for an entity----."² From the other side, another writes that: "Not only are their professional origins different, but also, from the beginning the two groups have had important diverse interests. At no time can either field of learning be looked upon as including the other; nor is either calling an off-shoot of the other."³ George O. May has said that where accounting and economic thought run along parallel lines, they do so because both are running parallel to business practice.

"Economists have always considered their subject to be a branch of social philosophy. They concerned themselves from the first with social problems and gave little thought to the individuals."⁴ The origin and development of accounting as a tool used to account for wealth and changes therein can not be considered as a branch off of social philosophy or economics. The origin of both disciplines is not of major importance. However, present day concepts and viewpoints held by each are a direct result of the different origin and purpose of each.

¹ George L. Bach, Economics, p. 3.

² Corbin, Loc. cit.

³ John B. Canning, Economics of Accountancy, p. 19.

⁴ Canning, P. cit., p. 6.

It is only natural that the two separate areas of study serving different needs and dealing with different problems should not use the same terminology or be in agreement with each other on basic concepts of income and its measurement.

The problems to be considered here are those caused by the points of common interest and concern to the two areas, however, and not their distinctive characteristics. Economists, like those groups discussed in the previous pages and depending on accounting statements, have looked to the accounting profession as a source of statistical information. As economics became less philosophical and theoretical in dealing with social problems, the need for more statistical information became greater. Business statistics accumulated and assembled by accountants has proven very useful in this respect but not entirely satisfactory. Like legal authorities, management and different segments of the public, economists are observing income in a different manner and the information obtained is used for different purposes.

Economists are primarily concerned with business income as it represents a segment of national income. National income, income of the production factors and of the individual as well as business income are of concern to the economist. These incomes are looked upon as a means of satisfying human wants and needs. For this reason much adjustment is necessary in order to make information obtained from accounting statements relevant to them. Unlike legal authorities, economists do not have the power to force their concepts of income and theories of income determination upon the accounting profession. Nevertheless, a closer association of economics and management in recent years has caused those concerned with business income to give greater consideration to the economic aspects of income determination.

As in other disciplines it is also not possible to set forth a concept of income representing the position of all economists. Scores of theories have been set forth attempting to establish economic definitions of income and procedures for measuring the income defined. Most economic concepts of income, however, are variations of a lesser number of general concepts. In the following pages an attempt will be made to set forth and compare these general concepts.

ECONOMIC CONCEPTS OF INCOME

In observing the various areas concerned with the problem of income measurement and the resulting influences upon the development of accounting principles and theory; it is natural to set Economics apart from the other areas. The regulatory agencies, tax authorities, investors, management and others are primarily interested in different aspects of income. These groups have proposed and/or demanded that certain principles and procedures be used for income measurement. Few of these procedures, however, are based on general theories and concepts of what "real" income is, or what income should be. Tax concepts of income can not easily be defined and when they are, exceptions are almost as numerous as the rules. The income involved may be determined by government's desire to encourage, regulate, or discourage certain types of business or even by political pressures.

Economics does not view income or approach the problem in this manner. It is approached from a theoretical point of view. What is income? What should true income measure? These are the questions which economists try to answer before attempting to measure the item. For this reason most of the disagreement and conflict over income theories and concepts arises between economic and accounting theories. Between the extremes of these two areas are many theories

of the subject too numerous to discuss but which have incorporated into themselves some of the thinking of both groups.

In discussing a subject so large as economic concepts of income it becomes necessary to define broad areas of concepts and general groups of theories which exist. Two basically different approaches to income measurement are evident in economic literature.

Income may be viewed as a return for some factor of production. Traditionally economists recognized these factors as land, labor and capital. All production was considered to be rent, labor and the residual or noncontractual element which was a return to those supplying capital. Due to the close relationship between ownership and management, these returns were called profits and little consideration was given to the separate functions involved. The French economist, Say, was among the first to distinguish among several elements of profit.¹ One of these elements was interest, the return for the function of supplying capital. Still no distinction was made between the functions of the entrepreneur and owner until some time later. In addition to those factors called rent, wages, interest and profits; more recent functional analysis of income have included the return to the entrepreneur. This development can be attributed to a great extent to the growth in size and number of large corporations in which management and ownership are separate groups. The term profits is now being used to identify a much smaller segment of the income stream than it previously did. Theories of profit have attempted to break it down still

¹ Robert Gordon, "Enterprise, Profits, and the Modern Corporation", Readings in the Theory of Income Distribution. p. 559.

further, attributing it to a number of factors. One writer¹ places these additional analysis of profits into three groups. 1) Theories relating profits to the entrepreneurial function and the supply and demand of entrepreneurs.

"Essentially these theorists stress coordination and control by the entrepreneur of the productive factors and processes as the function for which profits are a reward".² 2) Those theories relating profits to the competitive element of risk, uncertainty, innovations, control or combinations of these. 3) Those theories relating profits to monopolies or institutional positions of advantage.

This functional approach to income³ which relates it to some phase of the productive process is very difficult to reconcile with the business income referred to by accountants and businessmen. The above mentioned theories are based upon an input concept of income whereas business income is viewed as a result of the productive process.

Other economists have developed theories of income with an emphasis placed on the result of the productive process and not the cause. With the emphasis on out-put, income was measured in terms of consumption, or the aggregate value added by the factors of production as evidenced by the end product. Irving Fisher, J. M. Keynes and J. R. Hicks were among those observing income in this fashion.

Early in the twentieth century Irving Fisher wrote The Nature of Capital and Income. In this book Mr. Fisher distinguishes between capital and income in the following manner. "A stock of wealth existing at an instant of time is

¹ Ibid., p. 560

² Ibid., p. 560

³ Income is used here to refer to any increase in wealth resulting from production whether it be a result of wages, interest or other factors.

called capital. A flow of services through a period of time is called income."¹ Fisher's concept of income is basically a realization concept as implied by his use of the word services. Fisher also describes another income which he calls earned income and which includes changes in capital. Concerning this he writes: "increases in capital are not income in the sense that it can be discounted in addition to other items of income. Nothing but confusion can result from having to consider two kinds of income so widely divergent that whereas one is discounted to obtain capital value, the other is not."² In developing his realization theory, Mr. Fisher sets out three separate phases of income. These are: money income, objective income and subjective income. Money income is a monetary measure of one's consumption. Objective income refers to consumption expressed in equivalent units. The satisfaction received from the consumption is referred to as subjective or psychic income.

J. M. Keynes did not agree with Fisher that changes in capital should not be included in income. Mr. Keynes states that savings³ is the excess of income over expenditures for consumption. Income therefore equals consumption plus savings. "For the business enterprise net income is the figure which remains after all expenses, including all depreciation and obsolescence, have been deducted from proceeds."⁴ The time at which proceeds are recognized and the method used to measure these proceeds, depreciation and obsolescence, and other expenses will cause considerable variations in the application of this definition of

¹ Irving Fisher, The Nature of Capital and Income, p. 52.

² *Ibid.*, p. 249.

³ Savings in this sense refers to either a positive or negative change in capital not resulting from consumption.

⁴ Dudley D. Dillard, Economics of John Maynard Keynes, p. 65.

business income. It can be established, however that most current concepts of income give consideration to the changes in capital value which are a result of depreciation and obsolescence. This may appear to be an obvious procedure at the present time; however, one need not go back one hundred years in accounting and economic literature to find that depreciation is a relatively new part of income determination.¹

A definition of income that has provided a starting point for most current concepts of income was set forth by J. R. Hicks. For an individual² he defines income as "the maximum value which he can consume during a period and still expect to be as well off at the end of the period as he was at the beginning".³ Hicks justifies this definition by going one step further and saying that the purpose of income (its measurement) "is to serve as a guide for prudent conduct".⁴ Hicks has also added savings to Fisher's definition. In attempting to measure what Hicks defines as income one will at once encounter three points at which subjective interpretations must be made; thus giving rise to numerous concepts of income, all dependant on the one definition. The first problem in using Hicks' definition is that of expressing value. How will value be measured? The second problem arises in connection with the word expect. Variations in income according to Hicks, may thus be said to occur as the individual's expectations are changed. It would be extremely difficult to make any objective report or interpretation of an income which is dependent upon the expectations of each

¹ May, op. cit., p. 29.

² This definition can be adapted to business income by assuming that income is the amount by which net worth has increased, adjusted for contributions or withdrawals of capital.

³ J. R. Hicks, Value and Capital, p. 172.

⁴ Loc. cit.

entity involved and uniformity of the results could never be expected. Also his use of the term "as well off as" will cause great difficulty in application. Hicks himself points out that most of the problems in using his definition lie in determining what we mean by being as well off as.¹

A good definition must meet two tests: "It must be useful for scientific analysis; and it must harmonize with popular and instinctive usage."² Hicks' definition meets the second test. It leaves much to be desired when used for scientific analysis.

These theories of income held by the three economists mentioned above are not set forth here to represent the economic view of income. The definitions are, however, representative of the many attempts to define and segregate income as it accrues to the individual in the form of consumption, changes in capital values, or both. They serve as a basis for the numerous concepts and theories of business income.³

Whether one attempts to measure income as factors of production or as the result of production, certain variations must be made in the basic economic definitions of income for them to be applicable to business income. Business income accrues to an entity and not an individual. Even if the entity is a proprietorship, accountancy treats the owners equity in the business as if it were an individual person. In this sense business income is not measured by individual consumption nor does it represent the total return to the factors of production. It may, however, be considered as representing the entity's consumption (dividends) and savings (changes in net worth other than those

¹ Ibid., p. 173.

² Fisher, op. cit., p. 103.

³ Hicks' definition is an acceptable basis for both accounting and economic concepts.

caused by dividends). It may also contain interest on capital, entrepreneurial wages and possibly profit.¹

Concepts of business income may be divided between concepts of money income and real income. The use of the word real to distinguish between the two is not intended to communicate the idea of a true, actual or perfect income as derived in certain economic concepts. Real income is used here to describe that income, whatever the method of measurement, which is expressed in equivalent units of purchasing power. It is this income which Fisher calls objective income when referring to the individual. The task of expressing money incomes in real terms is not insurmountable. Sufficient consideration has been given to the subject of price-level adjustments to conclude that the adjustments can be made; painful and cumbersome as they may become for those preparing the statements.

To propose that any one concept of income can result in an absolute, true measurement may seem out of place in view of the discussion up to this point. It is not hard to define the object, however, when only the second of Fisher's afore-mentioned tests of a definition is used, i.e., it must harmonize with popular and instinctive usage. At the expense of having little practical value in regard to the accumulation of business data, concepts of income and corresponding methods of measurement exist which may be labeled true or ideal concepts of economic income. Two assumptions must be made in order to measure any such income, however. The first is that capital will be valued by discounting any future benefits at the subjective rate of interest. The second is that we have at all times a complete knowledge of the future benefits resulting from existing

¹ Profit here is used in the economic sense; it is that part of income which is in excess of a normal return for the factors of production.

capital and of the subjective rate of interest. Income in this case will be equal to the capital values at the beginning of the period less the capital value at the end of the period plus consumption for the period. Income measured in this manner is eliminated to interest on capital. One writer has suggested that this ideal concept of income should be a goal for the accounting profession to strive for. It would seem more fitting to the purpose of setting goals to erect those which would at least be within the reach of those concerned. Certainly all who are familiar with the problem will not hesitate to admit that our knowledge of the future, being limited and inaccurate, will cause changes in the forecast of future benefits and the subjective rate of interest. With this limited and inaccurate knowledge of the future, it is necessary to digress somewhat from the income which we would like to measure. We are forced to measure income on a more realistic and objective basis even though the result is only an approximation of the real income.

The first step away from the ideal income is represented by the ex-ante concept of economic income. This concept also holds that income should be based on consumption and changes in capital values which represent discounted future receipts. However, capital values are revised at the beginning of each period. The changes in the capital values result from the revisions in our projections of future receipts and interest rates. From one accounting period to another certain capital gains and losses will result from the revisions themselves of the capital values. These are not true gains in the economic sense but changes in capital values representing the changes in our own projections of the future. These gains are normally not included in ex-ante income for the period as they do not account for the deviation in the ex-ante income from ideal

income. Ex-ante income will, however vary from ideal income for the corresponding period (were we able to accurately determine the ideal income) by the interest on the capital gains or losses not recognized until the period is over.

These capital gains or losses produced by ex-ante measurements of income somewhat resemble the capital gains referred to by accountants to the extent that accounting capital gains may be attributed to imperfect expectations of the future which are reflected by changes in market values.

Ex-post concepts of obtained income are numerous and will vary from extremes. It is in this category that accounting concepts of income may be placed as well as an adjusted anticipated concept of capital interest, similar to the ideal income. Most of the basic differences between the accounting and economic views are evident and can be observed within the group of ex-post concepts. With some alterations in the assumptions and procedures, income as capital interest can also be observed in ex-post fashion.¹ In this manner, the gains or losses referred to above are determined at the end of the period and transferred back to the beginning of the period in order that capital interest will be based on values determined after the period is over. Differences exist over whether or not these gains should be used only in determining capital interest or whether they should be included in income for the period in which they were recognized. This problem has its counterpart which is the treatment of capital gains on the accounting statements. Like changes in the capital values, the capital gains are also a result of imperfect projections of the future which occurred in some previous period. J. R. Hicks in referring to these gains has stated that an income which includes them can have no relevance to present decisions. "The income which is relevant to conduct must always exclude windfall gains; if they occur

¹ Hansen, Op. cit., p. 28.

they have to be thought of as raising income for future periods (by interest on them) rather than as entering into any effective sort of income for the current period."¹

From observing the foregoing definitions and theoretical methods of income measurement one must conclude as Mr. Hicks did. "It seems to follow that any one who seeks to make a statistical calculation of income is confronted with a dilemma. The income he can calculate is not the true income he seeks; the income he seeks cannot be calculated."²

At this point the dilemma becomes a very real and practical problem for accountants. Adjustments must be made in the income which we seek in order that it may be calculated. These adjustments can only represent estimates of the real object. In view of the different backgrounds and objectives of those relying on the estimates and the different uses for them; the accountant's task becomes one of finding an optimum balance between the income we seek and one based on completely objective measures.

The basic concepts, assumptions and principles representing the accountants compromise of the two objectives are discussed in the following pages. These become much more logical when viewed as tools used to provide an estimate which all accountants recognize as being partially unobjective and partially unrealistic.

ACCOUNTING INCOME

Accounting has traditionally been concerned with historical events and their measurement. This emphasis is a natural outgrowth of bookkeeping procedures and their purpose from which accounting practice has been developed. Eco-

¹ Hicks, Op. cit., p. 179.

² loc. cit.

nomics rather, has been primarily concerned with the future and the decisions that must be made concerning the future. It is evident from previous parts of this paper that there is a growing dependence on accounting to provide information relevant to economic and managerial decisions. The analysis of accounting reports and statements of past operations is an increasing and integral part of the decision making process.

These developments have tended to draw the interests of economics and accounting closer together by providing more closely related objectives and purposes. The basic philosophies, concepts, principles and procedures developed by these groups to achieve the end results have not, however, reflected these developments. With a greater emphasis on income measurement the accounting concepts and principles underlying this function have been analyzed, criticized and discussed much more frequently and extensively. Much has been written criticizing these basic concepts but little progress has been made toward revisions and changes that would provide a better basis for current income measurement.

Financial statements prepared in generally accepted accounting fashion are based on conventions developed from experience of the profession. These conventions are a result of the accountant's efforts to recognize and serve the needs which have arisen. The necessity of having to place into practice what economists have been able to theorize on probably is cause for a lack of soundly developed concepts and concise principles within the profession. Underlying these conventions are several concepts or assumptions on which accounting procedures are generally based. These are summarized in the following paragraphs.

"A business entity is a formal or informal unit of enterprise----organized to accomplish certain express or implied purposes.----accounting procedures and financial reports are concerned with specific business entities and their activities. ----The business entity concept provides a basis for identifying economic resources and activities with specific enterprises, thus for defining the area of coverage appropriate to a given set of records or reports."¹

"The going concern concept assumes the continuance of the general enterprise situation indefinitely----the concept assumes that controlling environmental circumstances will persist sufficiently far into the future to permit existing plans and programs to be carried to completion----the assumption provides a reasonable basis for presenting enterprise status and performance."²

"The monetary unit is the principal unit of measure employed in accounting to record and report information about business events.----Price derives from the exchange of specific goods and services under actual market conditions and is prima facie evidence of the money value of such goods and services at the time of exchange."³

"The essential meaning of realization is that a change in an asset or liability has become sufficiently definite and objective to warrant recognition in the accounts. Typically the initial appearance of an asset within an entity is the result of an exchange transaction in which terms and amounts established by negotiation are supported by documents and market data."⁴

In addition to these underlying assumptions, certain definitions and prescribed procedures have been generally accepted by accountants which help one formulate a concept of the income to be measured.

Realized net income of an enterprise measures its effectiveness as an operating unit and is the change in its net assets arising out of the excess or deficiency of revenue compared with related expired costs; and other gains

¹ Accounting and Reporting Standards for Corporate Financial Statements, American Accounting Association, p. 2.

² Loc. cit.

³ Loc. cit.

⁴ Loc. cit.

or losses to the enterprise from sales, exchange or other conversions of assets.¹

As a primary component of business income, revenue is considered as "the monetary expression of the aggregate of products or services transferred by an enterprise to its customers during a period of time".²

As another aspect of income, expired costs must be properly separated from costs and properly measured. "The word cost is related to expenditure. An expenditure is a payment in cash or otherwise, or the incurring of an obligation to make a future payment, for a benefit received. Cost is the measure of the expenditure."³ An expired cost is a cost for which the benefit received has been used up or lost. Another so-called accounting concept indicates generally when the benefit received should be considered as used. The matching concept means that in the determination of periodic net income, it is imperative that revenues and related expenses be reported in the same period. Thus if revenue is deferred because it is regarded as not yet earned, all elements of expense related to such deferred revenue must be deferred also in order to achieve the matching of revenue and expense which is essential to a proper determination of net income."⁴

In addition to the problem of measuring revenues and costs, a problem of major proportions is that of timing. Determining when the change in an asset or liability has become sufficiently definite and objective to warrant recognition will involve much individual judgment. Certain principles or guides for rec-

¹ Ibid., p. 5.

² Loc. cit.

³ Finney and Miller, Principles of Accounting, p. 172.

⁴ Ibid., p. 183.

ognition have been set forth by the accounting profession. "Revenue is recognized upon the transfer of an asset, the performance of a service, or the use of a resource of the enterprise by another party accompanied by a concurrent acquisition of an asset or a reduction of a liability."¹ "Expense is recognized in the period in which there is: 1) a direct identification with current revenue 2) a measurable expiration of asset costs even though not associated with the production of revenue for the current period 3) an indirect association with revenue of the period."²

From the above definitions and concepts one can conclude that the business income measured by accountants represents a monetary concept of realized income based on historical costs and is measured ex-post.

ACCRETION INCOME

In an attempt to bridge the gaps between accounting theory and practice, attempts have been made to measure business income as changes in economic power which are evidenced by market values. "The accretion concept defines income as an increase in economic power which can be measured with reasonable objectivity. --income is the change in economic power adjusted for capital contributions and distributions."³ The definition is generally in agreement with Hicks' definition of economic income. It is the measure of economic power, however, that separates accretion from economic income. While economic income, for the most part, is based on the present value of future receipts discounted, accretion

¹ Accounting and Reporting Standards for Corporate Financial Statements, op. cit., p. 15.

² Loc. cit.

³ G. Edward Philips, "The Accretion Concept of Income", The Accounting Review, January 1963, 38:14.

income is dependent primarily on market values as a measure of economic power. The difference is of less importance than it first appears.

Should everyone have the same expectations of future receipts and discount these receipts at the same subjective rate of interest, discounted present values would theoretically be equal to current market values. The basic difference in the two is a result of revisions in our projections of the future causing capital gains and losses to appear in the market.

Since the lack of objectivity used in determining income is a major weakness in economic concepts, accretion income provides additional objectivity without digressing greatly from theoretical standards. The accretion concept, by indicating that economic power should be measured by market price only where it can be done with reasonable objectivity has left considerable room for different degrees of objectivity; thus causing problems when statistics are compared.

There are two basic weaknesses in the accretion concept.¹ 1) No distinction is made between income resulting from a change in the value of the monetary unit and normal income. By periodic revaluations of certain items the bunching effect of dollar changes is reduced, however. 2) No distinction is made between capital gains and income from normal operations. For the accounting profession it may include another weakness: that it tends to make appraisers of the accountants, a job which they have refused to accept in the past.

The whole accretion concept is based on a theory of value. Without a well developed value theory and generally accepted principles for application of the theory, an extreme lack of uniformity would result. Advocates of the theory

¹ Ibid., p. 19.

are quick to point out that consistency of practice should not be the ultimate test of a practical income theory. Since market values are a better measure of economic power than historical costs, income should be based on changes in market values whenever these are measurable. These advocates feel that "accretion income should be accepted as the ideal----a guide to be used in evaluating the merits of alternative practices."¹ This does not imply that the accretion concept will be applied to the measurement of all categories of assets. Obviously fixed assets would not be valued at the close of each period because of a lack of a market test for such items. This does not necessarily limit the purpose or value of income determination when the "going concern" is assumed. Most fixed assets will be used in the normal operation of the business, expire and never be subject to market values except as salvage. The practice of spreading their cost over estimated useful lives would continue to be used in income determination. "Although the accretion concept does not serve all needs for data, it has a striking degree of universality of applicability in many areas including taxation, national income measurement, and management decision-making."² It also would not require sudden and vast changes in accounting practice.

COMPLETELY SUBJECTIVE AND OBJECTIVE INCOMES

Income concepts may be extended beyond the limits of subjectivity and objectivity previously mentioned in this paper. These concepts have little or no value in dealing with business income, however, and will only be mentioned as extreme points of view.

¹ Ibid., p. 18

² Ibid., p. 25.

Psychic income or subjective income as it is termed by Fisher is completely dependent on individual judgment and opinion. It has no objective procedure for measurement. Psychic income represents the human satisfactions received as a result of the objective income. Fisher writes that "it is usually recognized by economists that we must not stop at the stage of objective income. Indeed no objective services are of significance to man except as they are preparatory to subjective satisfactions."¹ It is agreed that the satisfaction of human wants and needs with scarce resources is the objective of economics and psychic income is the end product. However, it is the measurement of income with which accountancy is primarily concerned. It is this measurement of income that must serve as a basis for prudent conduct and not the income itself. For this reason psychic income is not of great concern to the business entity whose consumption consists of dividend payments.

At the opposite extreme one can determine income by not recognizing any flow of services or products except as they are transferred into cash or its equivalent. Income is determined by deducting from cash receipts the cash expenditures for the period. At this stage an entirely homogeneous and consistent income is obtained. Although cash flow statements provide useful information for management purposes, their limitations in measuring changes in the economic power of a firm are obvious. Cash income is only mentioned here as an extreme example of the inverse relationship between objective income and that income we would like to measure.

¹ Fisher, op. cit., p. 165.

SUMMARY

The following outline will serve to set forth more clearly the basic concepts of income, and their relative positions in the progression from conceptual reality to complete objectivity.¹

- 1) **Psychic income**--Completely subjective. Income is a function of the satisfaction derived by the human body from the consumption of units of production.
- 2) **Income** is equal to consumption plus or minus changes in capital values. These capital values are determined by discounting future net receipts. Ideally this would suppose a perfect knowledge of future receipts and interest rates. In practical application it must be measured ex-post or ex-ante to each period in order to reflect the revisions which will occur in projections of the future.
- 3) **Accrual, Value Added or Accretion Income**--Basically similar to economic income, except that capital changes are determined by market values when these are measurable.
- 4) **Accounting Income**--Value changes are recognized normally when evidenced by outside transactions. All values are based on prices evidenced by business transactions.
- 5) **Cash Income**--Completely objective. Value changes are recognized only when evidenced by a cash transaction.

Variations in these concepts of income and the principles for measuring each, have tended to make the differences among them appear more numerous than they are. The basic differences in the central three incomes, those applying to business income, may be reduced to only three.²

The first and most basic of these is the real income measured by the present value method as opposed to money income obtained from the accretion and accounting concepts. This assumption that economic income is real income must be qualified

¹Philips, op. cit., p. 16.

²Sidney S. Alexander, Income Measurement in a Dynamic Economy, p. 94.

somewhat. It is supposed that because income is a function of future receipts and not past monetary values, the income obtained is free from all price level problems. However, to free the income from all variations in price levels it appears that it would be necessary to discount the changes in price levels that we suppose to occur in the future and that will effect our measurement of future benefits. By determining present value both for the beginning of the period and the end of the period at the same instant of time the income of the current period will reflect current purchasing power and be free from price level distortions. This does not make the current period income comparable with those incomes of past or future periods. Since all income is not consumed during the current period it does not represent purchasing power of the income at some future date when the savings are consumed. A knowledge of the value of the unit at the time it is to be received is necessary to the expression of real income regardless of the concept of income which is held.

Accretion income is basically a monetary measure as opposed to a real one. The effect of changing price levels will appear in the income statements in the same form as the real income. The two cannot be distinguished without the application of a price index. However, it does tend to prevent large fluctuation in income resulting from changes in the value of the dollar by reporting some of the changes in the price level within the period during which it occurs. Most gains are reported in current dollars but expired costs which haven't been revalued on the basis of market values will continue to reflect dollar values of past periods.

The second difference in the incomes derived by the various methods is caused by the inclusion or exclusion of capital gains. Economists normally

consider capital gains those which are attributed to the change in expectations of the future and therefore are windfall profits to be excluded from income of the period. Certainly in the measurement of social income these gains would have to be excluded but to the individual firm these represent changes in economic power and may represent better than the average managerial foresight. These probably have little significance in managerial decisions of the future. Except for certain financial institutions capital gains included in accounting income generally are not included until realized; therefore minimizing the problem of measuring them. There are differences of opinion concerning where unusual and non-recurring capital gains should be included in the statements. One must assume, however, that those using the statements have enough understanding to make such minor adjustments as this to serve their own needs and the problem is of little significance in determining income. The fact that it has been realized and has increased the economic power of the entity is important to those concerned. Like accounting income, accretion income includes the capital gains in income for the period. The period in which the gains are reported will normally be different, however. Accretion income includes capital gains as soon as they are sufficiently reflected by market values to objectively measure. This generally will result in a much sooner realization of gains by accretion than by the accounting method. The treatment given such gains under the accretion method has the advantage of showing the increase in value when it did occur. Since capital gains are a result of changes in expectations caused over time it is more realistic to assume that they are a result of factors beyond management's

control. Therefore the recognition of such gains should not depend on a management decision to convert the asset. In summary economic income normally will exclude capital gains from income, accretion income will always include such gains and accounting income will normally include them but will not do so until realized.

The third point of variance is that of timing. Economic income includes revenues as soon as they are anticipated in the form of future receipts. Accretion income recognizes an item of revenue only when it can be reasonably and objectively measured by market values. In essence this is when the market recognizes the value of the future receipts. Accounting income requires an exchange of assets as evidence that the revenue has been realized.

It can be reasoned that all differences of income theory and measurement could be resolved by resolving these three specific problems. In practice such a reconciliation is not likely.

CONCLUSION

Little progress can be made in the area of income determination until the following questions are placed in proper perspective with each other and given careful consideration.

- 1) What is income i.e., what does income measure?
- 2) How can income best be measured?
- 3) Why measure income?

Answers to the first question will contribute little to income determination problems if they are founded on narrow definitions. Basically, we are attempting to measure an entity's progress over a given period of time as evidenced by its increase in economic power or command of goods and services. Income should

not be a definition of workable and acceptable procedures, but rather, one based on the concept of enterprise progress. It is a success indicator; and the difficulties of implementing it as such should not distort the object itself.

Answers to the second question have been clouded by a lack of consideration of and agreement on the previous one. The accounting profession has been faced with the problem of trying to measure something that has not been clearly defined by the profession nor by those for which the measurement is made. The results have been less than satisfactory to most everyone concerned. How income can best be measured must be considered from two viewpoints. How can we most correctly measure the income and how can the information be made most useful? These questions must be considered together and not separately. Assuming that a perfect solution cannot be reached for either, the question becomes how far must we deviate from an attempt to measure the income defined to make the results useful to those concerned. Some deviation from the income we would like to measure is necessary to gain a sufficient degree of objectivity. A comparison of psychic and cash incomes makes this point obvious.

Last but not least the accountant must remember that his reports are many things to many people. The specific use to be made of the income data must be kept in mind. The first parts of this paper point out the increasing importance of this question.

The accounting profession is being criticized for the out-dated methodology currently being used to determine income. It is accused of failing to recognize the problems and changes caused by a dynamic economy and for a rigid traditionalism preventing changes in practice when the need is recognized. Those without

have accused those within the profession of protecting their "sacred cow" called generally accepted accounting principles.

The accusation that methodology and procedures are out-dated is perhaps justified; but for the majority of those confronted with the problems of income measurement, the others are not. Accountants generally recognize that to the extent that the balance sheet can be made to represent an entity's true economic position as of a given time, real income can be accurately measured. The basic problem within the accounting profession appears rather to be a reconciliation of the answers to questions one and three mentioned above. Because of this failure to reconcile concepts and workable procedures accountancy has developed or rather evolved from procedures of ancient bookkeeping and not from well grounded concepts and well established objectives and purposes.

Because of the numerous uses of accounting data and the number of weak concepts underlying these uses, there can not be a reconciliation of the best measurement of true income and the information prepared for the various purposes. The accounting profession must realize however, that it is professionally responsible for both. Accounting income must be reported on a sufficiently objective and homogeneous basis to make the results comparable in all cases. If the profession is to keep pace with changes and resulting needs for additional information, and retain its professional objective as one of providing service, numerous adjustments and changes in concepts and procedures must take place at each avenue of service.

This means that for general purposes there must be an accounting concept of income based on well established standards and a clear understanding of objectives, not on the historical development of convenient procedures. It means that

accounting services must become sufficiently broad and flexible to provide the types of information that are needed and requested. At this level there must be a complete understanding of the entire problem of income determination in order to provide the analysis and interpretations necessary to make the reports useful.

George O. May expresses a similar view of the problem and possible solution in the following statement made in 1948.

Cutting across and impeding progress in the researches which aim at greater significance in accounts there is in America a powerful movement which would subordinate significance to a supposed uniformity and certainty. Accountants are told that they have an obligation to produce accounts which will be simple, adequate, truthful and understandable by the common man and will, at the same time, suit all the principal purposes for which accounts are used.

The movement has its origin in distrust of management, coupled perhaps with faith in the standardization that has proved to be invaluable in industry. But income determination is used for many purposes, and the American multiple-use tool is typically not a makeshift device which performs a variety of tasks unsatisfactorily. It is rather (like the cultivator) a combination of a main component and a number of attachments, each intended for a single purpose. It may be along this line that increased usefulness of income determination can best be achieved.¹

Undoubtedly there has been an increase in the preparation and use of supplemental income data by accounting firms for individual clients since Mr. May's statement was made. However, developments along this line within the accounting profession and the satisfaction of those concerned do not reflect a great amount of progress since Mr. May's observation sixteen years ago. .

¹ May, op. cit., p. 82.

Once we have developed a greater understanding of the problem itself and of the objectives and purposes of income determination a major part of the problem will have been solved. Until this first step is completed, a change in procedures and tools for income determination will only add to the confusion and dissatisfaction that are associated with statements of business income.

ACKNOWLEDGMENT

The writer wishes to acknowledge his appreciation to the members of his committee and to Professor James B. Hobbs for their help and suggestions in the preparation of this report. He also wishes to thank each member of the College of Commerce faculty for his valuable guidance and instruction throughout the entire period of study.

BIBLIOGRAPHY

- Alexander, Sidney S. Income Measurement in a Dynamic Economy. New York: American Institute of Accountants, July 1950.
- American Accounting Association. Accounting and Reporting Standards for Corporate Financial Statements. Columbus, Ohio: 1957.
- American Institute of Certified Public Accountants. Accounting Research and Terminology Bulletin. New York: 1961.
- Bach, George Leland. Economics. Englewood Cliffs, New Jersey: Prentice-Hall, 1958.
- Bangs, Robert B. "The Definition and Measurement of Income". The Accounting Review. September 1940, 15:353-370.
- Bedford, Norton M. "Accounting and Economic Concepts". The Journal of Accountancy. May 1957, 103:56-62.
- Bowers, Russell. "Tests of Income Realization". The Accounting Review. June 1941, 16:133-138.
- Canning, John B. The Economics of Accountancy. New York: Ronald Press, 1929.
- Carey, John L. "Legal and Accounting Concepts". The Journal of Accountancy. November 1938, 66:281-285.
- Chang, Emily Chen. "Business Income in Accounting and Economics". The Accounting Review. October 1962, 37:636-644.
- Chase, Stuart. How to Read an Annual Report. New Jersey: Standard Oil Company, n.d.
- Corbin, Donald A. Accounting and Economic Decisions. New York: Dodd, Mead, 1964.
- Dean, Arthur H. Business Income Under Present Price Levels. n.p., 1949.
- Dean, Joel. "Measurement of Profits for Executive Decisions". The Accounting Review. April 1951, 26:185-196.
- Dillard, Dudley. The Economics of John Maynard Keynes. New York: Prentice-Hall, 1949.
- Edwards, Edgar O. and Philip W. Bell. The Theory and Measurement of Business Income. Berkely, California: University of California Press, 1961.
- Finney, H. A. and Herbert E. Miller. Principles of Accounting. Englewood Cliffs, New Jersey: Prentice-Hall, 1958.

- Fisher, Irvin. The Nature of Capital and Income. London: Macmillan & Co., 1906.
- Gilman, Stephen. Accounting Concepts of Profit. New York: Ronald Press, 1939.
- Gordon, Myron J. "Scope and Method of Theory and Research in the Measurement of Income and Wealth". The Accounting Review. October 1960, 35:603-618.
- Grady, Paul. "The Quest for Accounting Principles". The Journal of Accountancy. May 1962, 113:45-50.
- Greer, Howard C. "Managerial Accounting--Twenty Years from Now". The Accounting Review. April 1954, 29:173-185.
- Hansen, Palle, The Accounting Concept of Profit. Amsterdam: North-Holland Publishing Company, 1962.
- Hicks, J. R. Value and Capital. London: Oxford Press, 1939.
- Husband, George R. "Rationalization in the Accounting Measurement of Income". The Accounting Review. January 1954, 29:3-14.
- Johnson, Charles E. "A Case Against the Idea of an All-Purpose Concept of Business Income". The Accounting Review. April 1954, 29:224-243.
- Lindahl, Erik. Studies in the Theory of Money and Capital. New York: Rinehart & Company, 1939.
- Littleton, A. C. Essays on Accountancy. Urbana, Illinois: University of Illinois Press, 1961.
- May, George O. Business Income and Price Levels. New York: American Institute of Certified Public Accountants, 1949.
- Moonitz, Maurice. "Should We Discard the Income Concept?". The Accounting Review. April 1962, 37:175-180.
- Paton, William, "A Statement of Accounting Principles". The Journal of Accountancy. March 1938. 65:196-207.
- Paton, W. A. and A. C. Littleton. An Introduction to Corporate Accounting Standards. Columbus, Ohio: American Accounting Association, 1940.
- Philips, G. Edward. "The Accretion Concept of Income". The Accounting Review. January 1963, 38:14-25.
- Scoville, H. T. "An Effort to Define Business Income". The Accounting Review. October 1952, 27:458-456.
- Solomons, David. "Economic and Accounting Concepts of Income". The Accounting Review. July 1961, 36:374-383.

Storcy, Reed K. "Revenue Realization, Going Concern and Measurement of Income". The Accounting Review. April 1959, 34:232-238.

Windal, Floyd W. "The Accounting Concept of Realization". The Accounting Review. April 1961, 36:249-258.

AN ANALYTICAL COMPARISON OF
VARIOUS CONCEPTS OF BUSINESS INCOME
AFFECTING THE ACCOUNTING FUNCTION OF
INCOME DETERMINATION

by

ROBERT J. MONROE

B. S., KANSAS STATE UNIVERSITY, 1961

AN ABSTRACT

OF

A MASTER'S REPORT

submitted in partial fulfillment of the
requirements for the degree

MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1965

One of the primary functions of accounting is the determination of business income. Due to various uses of income data by numerous groups with different interests, widespread disagreement exists over what income should represent and over the procedures used to measure income.

As a result of an increase in the number of uses for accounting reports, the growing importance of accounting data, and the extensive changes which have taken place in the business environment; income determination has become an increasingly complex problem in recent years.

Attempts to measure an entity's progress over a given period of time as evidenced by its absolute increase in economic power or command over goods and services do not provide sufficiently objective information to be of practical value. As one attempts to measure the change in an entity's economic position more objectively and make the reports comparable and more useful, some degree of conceptual reality must be sacrificed.

The purpose of this paper is to discuss various uses and concepts of income and to analyze the basic differences in these concepts in light of the accounting problems of measuring and reporting income.

The following outline will serve to set forth more clearly the basic concepts of income and their relative positions in the progression from conceptual reality to complete objectivity.

- 1) Psychic Income
- 2) Economic Income
- 3) Accretion Income
- 4) Accounting Income
- 5) Cash Income

Major differences among the three central incomes above, those applicable to the business entity, may be reduced to only three. First, economic income, to a certain extent, measures real income while accretion and accounting income

are monetary measures. Secondly, economic income excludes capital gains from period income. Accretion income and accounting income include capital gains in income although they normally will do so during different time periods. The third point of variance is timing. Economic income will include items of income as soon as they can be anticipated in the form of future receipts. Accretion income will include those items of income that can be reasonably measured by market values. Accounting income includes income which has been evidenced by a business transaction.

Any solutions to the problems of determining business income must be preceded by careful consideration of the following questions.

- 1) What is income? i.e., what does income measure?
- 2) How can this income best be measured?
- 3) Why measure income? i.e., for what purpose will the reports be used?

Accounting income must be reported on a sufficiently objective and homogeneous basis to make the results comparable in different cases and at different times. However, if the profession is to keep pace with changes and the resulting needs for additional information, numerous adjustments and changes in concepts and procedures must take place at each avenue of service.

This means that for general purposes there must be an accounting concept of income based on well established standards and a clear understanding of objectives, not on the historical development of convenient procedures. It means that accounting services must become sufficiently broad and flexible to provide the types of information that are needed and requested. At this level there must be a complete understanding of the entire problem of income determination in order to provide the analysis and interpretations necessary to make the reports useful.